

Ratings Report

Moody's assigns positive outlook to Somerville, MA's GO rating

Assigns MIG 1 to \$40.9M GO BANs, affirms Aa2 on \$95.9M GO debt

Moody's Investors Service has assigned a MIG 1 rating to the city of Somerville MA's \$8.9 million Series A General Obligation Bond Anticipation Notes (dated June 11, 2015 and payable October 16, 2015), and \$32 million Series B General Obligation Bond Anticipation Notes (dated June 11, 2015 and payable June 10, 2016). Concurrently, Moody's has assigned a positive outlook and affirmed the Aa2 underlying rating on the city's \$95.9 million in outstanding GO debt.

SUMMARY RATING RATIONALE

The MIG 1 rating reflects the city's strong underlying long-term credit strength, sufficient liquidity and adequate management of refinancing risk. The rating also incorporates the city's successful access to the capital markets as a frequent issuer over the last five years.

The Aa2 rating reflects the city's sizeable tax base which has experienced significant growth in recent years due to ongoing redevelopment efforts. Additionally, the Aa2 incorporates the stable financial position supported by healthy reserve levels, as well as manageable long-term liabilities for pension and OPEB.

OUTLOOK

The positive outlook reflects our expectation that the city will continue to prudently manage its financial operations and maintain its reserves at a minimum of the current levels. Additionally, growth in the tax base is expected to continue due to ongoing redevelopment efforts which are bolstered by the approved Green Line extension project.

WHAT COULD MAKE THE RATING GO UP

- Continued tax base expansion, and improvement in resident wealth levels
- Continued improvement in available reserves
- Reduced reliance on annual free cash appropriations

WHAT COULD MAKE THE RATING GO DOWN (removal of the positive outlook)

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- Material declines in the tax base
- Lack of additional tax base expansion
- Deficit operations and failure to maintain structural balance
- Significant reduction in reserves
- Significantly increased debt burden beyond current expectations

STRENGTHS

- Sizeable tax base
- Strong and growing economy in Boston-metro area
- Healthy reserve levels
- City maintains and adheres to formal financial policies

CHALLENGES

- Sizeable long-term pension liability
- Socioeconomic indices trail the state median
- City relies on annual free cash appropriations

RECENT DEVELOPMENTS

The city ended fiscal 2014 with a modest decline in general fund balance as a result of not fully replenishing an initial \$3.5 million appropriation of reserves. At year end, total General Fund balance declined slightly to \$46.5 million, or a healthy 22.2% of revenues. As the city approached the end of fiscal 2015, management is anticipating a modest surplus despite overspending on snow and ice and an initial use of \$3.5 million in reserves to balance the budget.

DETAILED RATING RATIONALE

ECONOMY AND TAX BASE: SIGNIFICANT NEW DEVELOPMENT EXPECTED FOR SIZEABLE TAX BASE IN METRO BOSTON

New growth in Somerville is expected to continue to be above average over the near term, given its favorably located tax base in the Greater Boston (Aaa stable) economy. Additionally, the base benefits from management's ongoing commitment to redevelopment activity, which is supported by the approval of the Green line extension project, which will add 6 new subway stops in the city by 2020.

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After experiencing three consecutive years of assessed value declines from 2007 to 2010, the city saw modest growth of 0.4% in fiscal 2011, 1.1% in fiscal 2012, and 2.4% in fiscal 2013. In fiscal 2014 and 2015, however, the city saw substantial tax base increases of 9.9% and 11.1%, respectively, reflecting numerous large scale developments reaching the tax rolls, as well as appreciation of the residential market. As a result of this growth, the city's equalized value has tripled to over \$10.4 billion from \$3.17 billion in 1998.

To capitalize on Somerville's desirable location and to facilitate future growth, city management has embarked on an ambitious economic development plan, including commissioning various feasibility studies to identify potential projects, rezoning initiatives to facilitate investment and pursuit of state and federal grant funds. One of the drivers for the city's recent growth has been the 145-acre Assembly Square Project, including two million square feet of office space, over 2,000 housing units, and 1.2 million square feet of retail space which includes shopping, dining, and entertainment. The site is now directly served by a newly constructed subway stop on the Massachusetts Bay Transportation Authority's (MBTA, Aa1 stable) orange line, which opened in November of 2014. Additionally, Partner's Healthcare System, MA (Aa3 stable) is currently constructing its new 875,000 square foot headquarters on this site.

In addition to the Assembly Square project, significant redevelopment has begun in the city's Union Square neighborhood. The Massachusetts Department of Transportation is moving forward with its Green Line extension, which will add a total of six new subway stops in the city of Somerville, and one in neighboring Medford (A1). The project will be funded using almost \$1 billion in federal grants, with the remaining \$1.3 billion being paid by the state. The first two stops (including Union Square) are slated to open in 2017, with the remaining to be operational by 2020. The extension of public transportation in the city will likely spur major ongoing development in the adjacent areas.

Portions of Tufts University (Aa2 stable) lie within the city and the university's presence provides economic stability as well as significant employment opportunities. Although a tax-exempt entity, the city benefits from annual payments-in-lieu of taxes of \$275,000 and affordable rental rates of university-owned property utilized for city operations. The city's sizeable student population (about 14% of total population according to the 2000 census), drawn from Tufts, as well as nearby Harvard University (Aaa stable) and Massachusetts Institute of Technology (Aaa stable), partially depresses the city's income indices, expressed by 2012 median family income and per capita income of 85.8% and 94% of the commonwealth, respectively. Positively, income levels in the city have improved slightly over fiscal 2000 levels, when median family income and per capita income were 83% and 91% of the commonwealth, respectively. Unemployment typically trends lower than state and national averages and in March of 2015 stood at 3%, comfortably below the state and national jobless rates of 5% and 5.6%, respectively.

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FINANCIAL OPERATIONS AND RESERVES: STABLE FINANCIAL POSITION WITH HEALTHY RESERVES

Somerville's financial position is expected to remain stable in the near term, given the city's conservative budgeting approach and ample reserve levels. The city's fiscal 2014 budget was balanced with a \$3.5 million appropriation of free cash and a 5.6% levy increase. At year end, the city recognized a modest operating deficit of approximately \$532,000, as a result of not fully replenishing the initial free cash appropriation. Total General Fund balance at the end of fiscal 2014 was \$46.5 million, or a healthy 22.2% of revenues, while Unassigned General Fund balance was \$15.5 million, or a satisfactory 7.4% of revenues. At this level, the city remains compliant with its policy to maintain unassigned fund balance at a minimum of 5%.

The fiscal 2015 budget was a 3.3% increase over fiscal 2014, and was balanced with an appropriation of \$3.5 million of free cash and a 5.2% increase to the levy. As a result of the especially harsh winter in the region, the city overspent its snow and ice budget by approximately \$9.5 million, however this deficit was reduced to \$2.2 million through departmental savings and the use of free cash and stabilization funds. The remaining \$2.2 million snow deficit will be amortized over the next three years (\$716,000 annually) as allowed under Massachusetts Law. As the city approaches the end of the fiscal year, a modest increase to total General Fund balance is expected, despite the snow deficit, due to favorable revenue variances in other areas.

The fiscal 2016 budget has not yet been adopted but includes a proposed 4.4% increase in spending, which will be offset with a \$3.5 million use of free cash.

The city receives the majority of its revenues through property taxes (55% of 2014 revenues) followed by intergovernmental aid (32%). The city's primary expenditures are for education (27% of 2014 expenditures), followed by employee benefits (25.2), public safety (17.1%), and public works (10.9%).

Liquidity

The city's net cash position at the close of fiscal 2014 was \$52.5 million, an estimated 25.1% of revenues. The liquidity position allows for strong coverage of 100% of total BANs outstanding, including the current issue.

DEBT AND PENSIONS

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It is anticipated that Somerville's debt position will remain manageable due to its average net direct debt and affordable planned future borrowings. Incorporating the current issuance, Somerville's net direct debt is on par with the commonwealth median at 1.1% of full value. The city's debt burden increases to 4.6% when incorporating overlapping debt from the Massachusetts Water Resources Authority (Aa1 stable) and the MBTA. After incorporating partial reimbursement from the Massachusetts School Building Authority (Aa2 stable), the city's adjusted debt burden declines slightly to 4.5% of full value. On a current year basis, debt remains affordable, representing a modest 4.7% of General Fund expenditures, which is below the city's policy to keep debt service below 5%.

The city maintains a formal five-year capital plan with a total investment of approximately \$183 million, to be funded through a combination of General Obligation Bonds, State Loans, and Grant proceeds. The majority of the plan focuses on infrastructure maintenance with improvements to the union square area and other portions of the city expecting to benefit from new subway stops.

Debt Structure

All of Somerville's debt is fixed rate, and principal amortizes at a below average pace of 66% within 10 years.

Debt-Related Derivatives

Somerville has no derivatives.

Pensions and OPEB

The city maintains its own retirement plan for all employees, with the exception of teachers and certain school administrators. The city is required by the state to fully fund its required pension contribution, which was \$12.2 million in 2014, representing a manageable 5.8% of General Fund expenditures. Under Moody's methodology for adjusting reported pension data, the city's combined adjusted net pension liability is \$367 million, or a slightly above average 1.77 times General Fund revenues. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the city's reported liability information, but to improve comparability with other rated entities.

In February of 2012, the city established a trust fund for its Other Post-Employment Benefits (OPEB) liability, which has been funded by annual appropriations, and has a current balance of approximately \$600,000. In fiscal 2014, the city funded 48% of the OPEB ARC, representing \$9 million. The total Unfunded Actuarially Accrued Liability (UAAL) for OPEB is \$285 million, as of

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June 30, 2014. This represents a significant decline from the 2008 valuation, where the unfunded liability for OPEB was estimated at \$570 million. The city has reduced this liability through employee contract revisions and transferring to the state-run Group Insurance Commission (GIC).

MANAGEMENT AND GOVERNANCE

Massachusetts cities have an institutional framework score of 'Aa' or strong. The primary revenue source for most Massachusetts municipalities is property taxes which are highly predictable and can be increased annually as allowed under the Proposition 2 ½ levy limit. Expenditures are largely predictable and cities have the ability to reduce expenditures.

Somerville's management team exhibits prudent budgetary practices and maintains several formal policies which help to guide financial operations.

KEY STATISTICS

- 2015 Equalized Valuation: \$10.4 billion
- 2015 Equalized Value Per Capita: \$137,901
- Median Family Income as % of US Median: 112.1%
- Fiscal 2014 General Fund balance as a % of Revenues: 22.42%
- 5-Year Dollar Change in Fund Balance as % of Revenues (2010-2014): 10.33%
- Fiscal 2014 Cash Balance as % of Revenues: 25.28%
- 5-Year Dollar Change in Cash Balance as % of Revenues, adjusted (2010-2014): 7.97%
- Institutional Framework: "Aa"
- 5-Year Average Operating Revenues / Operating Expenditures (2010-2014): 1.01x
- Net Direct Debt as % of Full Value: 1.07%
- Net Direct Debt / Operating Revenues: 0.5x
- 3-Year Average of Moody's ANPL as % of Full Value: 2.35%

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- 3-Year Average of Moody's ANPL / Operating Revenues: 1.2x

OBLIGOR PROFILE

Somerville is the most densely populated municipality in New England, with an estimated population of 78,804. The city is favorably located directly north of Boston, and is directly served by rapid transit.

LEGAL SECURITY

Debt service on the notes and all rated debt is secured by the city's GO limited tax pledge as debt service has not been exempt from the property levy limitations of Proposition 2 ½.

USE OF PROCEEDS

The notes are being issued fund various city capital needs.

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